Ontario

City of Toronto
Monetization Considerations

October 19, 2016

CONFIDENTIAL & COMMERCIALLY SENSITIVE

Context

- The City of Toronto has looked at options for monetizing its interest in Toronto Hydro several times in the past
  - A 2010 report suggested while a sale of a minority interest would not impede the City's policy objectives, the Provincial departure tax and transfer tax that is due upon sale of more than 10% ownership share of Toronto Hydro has historically made divestment unattractive
- In August 2016, the City of Toronto issued an RFP seeking an advisor to review and evaluate investments in Toronto Hydro and Toronto Parking Authority and recommend options for optimizing City financial returns
- Given the Province's experience with Hydro One, recent discussion and amendments to tax rules as well as common priorities among the City and Province, the following presentation attempts to highlight some considerations for the Province as it looks to assist the City in its review

Toronto Hydro

Potential Monetization Options Overview

- While a broad range of monetization options can be considered to unlock value in the City's investment interests, the following outlines potential considerations for select mechanisms:

	IPO	Strategic Sale	Leveraged Recapitalization
Description	• Common shares would be sold through public markets and shares listed on a stock exchange	• Selling a minority stake, majority stake, or 100% of the company to one or more investors	• Raise debt to fund a one-time dividend to the City
Transaction Costs	• Underwriters fees, the largest portion of IPO costs, can range from 4-10% of gross proceeds*	• Much lower than in a public offering, typically success fee based as percentage of sale price	• Lower than in a public offering
Public Policy Priorities and Governance	• Limits ability to influence company to meet public policy objectives • Subject to ongoing market scrutiny for its business decisions and financial results	• Limits ability to influence company to meet public policy objectives • Adding constraints on governance and public policy objectives could impact value	• Would likely not compromise governance or being able to meet public policy objectives as ownership would be maintained
Other Considerations	• Provides an avenue to sell a partial stake and raise capital to fund growth over time • Public companies also tend to be valued higher than private companies, resulting in higher proceeds in subsequent share sales	• Limited universe of potential investors for a minority position • Sale of 100% of the company would eliminate ongoing dividends to the City	• Impact the new capital structure would have on the regulated rate of return • Potential for downgrade from credit rating agencies • Cost of borrowing relative to the City taking on debt directly

Toronto Hydro

Valuation

- There are a number of different ways that can be used to value Toronto Hydro

1. Rate Base Multiple

- The Hydro One offerings and current market prices suggest that Hydro One's market valuation has been equivalent to about a rate base multiple (market value of equity + debt over rate base) ranging between 1.3 – 1.5x.
  - At similar multiples, Toronto Hydro equity may be valued at about **$2 - $3B** vs. a book value of $1.4B as at June 30, 2016.
- It should be noted that Toronto Hydro is smaller than Hydro One and focused on urban distribution, not transmission. This could lead to different, and possibly lower, multiples than the ones observed for Hydro One

2. Price Earnings Multiple

- Preliminary estimate of value for 100% of Toronto Hydro Corporation is **$2.4B - $2.7B**
- This represents a purchase multiple of 19.2x to 21.2x estimated normalized earnings of $126M (high level estimate based on 2016E deemed ROE of 9.19% on 2016 Q2 equity)
- The preliminary analysis excludes impact of transaction costs, departure taxes, transfer taxes, or control premiums / private discounts

Purchase Multiple Assumptions	
Based on Hydro One 2016E P/E	**20.9x**
Adjustments	
Less: Differences in scale	*-0.50x*
Add: Better growth rates/capex	*0.75x*
Net adjustment	0.25x
Upper range for Toronto Hydro	***21.2x***
Less: Hydro One Premium to Comps	*-2.0x*
Lower range for Toronto Hydro	***19.2x***

*Note that these are a rough indicator of market valuation, as market would take into account Toronto Hydro specific issues, such as governance, current earnings experience and potential growth, as well as dividend yields

Considerations

Potential for Hydro One transaction

- Hydro One has been active in consolidating local distribution companies in Ontario. As the largest local distribution company, Toronto Hydro could be an attractive acquisition target
- Any involvement of Hydro One carries additional considerations, including:
  - **Potential Dilution of the Province's Ownership Stake:** This could result if Hydro One raises capital by issuing additional shares in Hydro One
    - The Province may be finished selling shares in Hydro One by the time a THC transaction occurs (expect 1 year to prep company and >1 year for OEB approval if required)
    - Based on preliminary estimates, Hydro One may have sufficient capacity to finance a potential acquisition of THC using mostly debt, subject to a number of considerations
      - Its desire to maintain its value premium to comparables and avoid excessive financing risk
      - Financial ratios remaining at levels so as to not significantly compromise its credit rating
      - Staying largely within the OEB's deemed debt/equity ratio of 60/40

Hydro One - Estimated Debt Capacity* ($ in M)

	Current capital structure	% of Total	Debt Added	% of Total	Est. Debt Capacity
Total net debt	$10,543	52%	$14,833	60%	$4,290
Total equity	$9,893	48%	$9,893	40%	
Total capital	$20,436	100%	$24,726	100%	

*Based only on OEB capital structure of 60/40 debt/equity split and not on other risk or credit considerations

    - Assuming the Province's share sales are complete, the Province would have a pre-emptive right to protect its position by subscribing for and purchasing up to 45% of any share offering
    - The Province could also consider insulating itself from modest-sized equity issuances by maintaining a buffer (e.g. 5%) above the 40% target threshold
  - **Conflict of interest**: Potential perceived conflict of interest in supporting a Hydro One purchase, given the Province's ownership interest in the company

Toronto Hydro
Potential Proceeds

- The potential up-front proceeds that could be generated, and PILs / tax implications, would be dependent on a number of factors, including
  - The state of the market (e.g., equity market appetite, interest rate environment)
  - The size of the initiative (9.9% sale, 49% sale, 100% sale)
  - The type of monetization option considered (IPO, strategic sale, leveraged recapitalization)